Nos. 22,013 - 22,018

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

LEON W. SCALES and KATHLEEN A. SCALES,
Plaintiffs

v.

ROBERT A. RIDDELL,
Defendant-Appellant

ALLEN J. SUTHERLAND and ESTELLA W. SUTHERLAND,
Plaintiffs

v.

ROBERT A. RIDDELL,
Defendant-Appellant

A. PAUL SUTHERLAND and MARLEINE G. SUTHERLAND,
Plaintiffs

v.

ROBERT A. RIDDELL,
Defendant-Appellant

MONA J. MASON (FORMERLY MONA J. PARKER),
Plaintiff

v.

ROBERT A. RIDDELL,
Defendant-Appellant

JOSEPH LEVIKOW, JR. and ELIZABETH M. LEVIKOW,
Plaintiffs

v.

ROBERT A. RIDDELL,
Defendant-Appellant

FRED J. HOWARTH and PAULINE J. HOWARTH,
Plaintiffs

v.

ROBERT A. RIDDELL,
Defendant-Appellant

ON APPEALS FROM THE JUDGMENTS OF THE UNITED STATES DISTRICT
COURT FOR THE CENTRAL DISTRICT OF CALIFORNIA

REPLY BRIEF FOR THE APPELLANT

MITCHELL ROGOVIN,
Assistant Attorney General.

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No. 22,014

ALLEN J. SUTHERLAND and ESTELLA W. SUTHERLAND, Plaintiffs v.
ROBERT A. RIDDELL, Defendant-Appellant

No. 22,015

A. PAUL SUTHERLAND and MARLEINE G. SUTHERLAND, Plaintiffs v.
ROBERT A. RIDDELL, Defendant-Appellant

No. 22,016

MONA J. MASON (formerly MONA J. PARKER), Plaintiff v.
ROBERT A. RIDDELL, Defendant-Appellant

No. 22,017

JOSEPH LEVIKOW, JR. and ELIZABETH M. LEVIKOW, Plaintiff v.
ROBERT A. RIDDELL, Defendant-Appellant

No. 22,018

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ON APPEALS FROM THE JUDGMENTS OF THE UNITED STATES DISTRICT
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REPLY BRIEF FOR THE APPELLANT

1. In their "Brief for Appellees" the taxpayers first argue (Br. 6-14) that this Court need not even consider the substantive issues involved herein but rather should dismiss the Government's appeal on the ground that it is taken from a stipulated or consent judgment of the District Court.

This Court, pursuant to taxpayers earlier motion to dismiss which asserted "that a consent or stipulated judgment would not be appealable", has already ruled on this issue and by its order upheld the Government's appeal. That order was made the subject of a petition for certiorari by taxpayers which was denied by the Supreme Court. In our memorandum

in opposition to that petition we stated:

> The issue here is not, as the petitioners state (Pet. 2), whether a consent or stipulated judgment is appealable, but whether the district court's judgment is a consent judgment. In the orders of February 17 and May 31, 1966, the district court, on the basis of a contested motion for summary judgment, disposed of the question whether money and land petitioners received as holders of certain deeds of trust were taxable as ordinary income or as capital gain. That decision left open a third issue concerning the fair market value of the land. This third issue was the only matter stipulated or agreed to through the so-called "Stipulated Judgment" of March 16, 1967. The limited effect of the "Stipulated Judgment" is made plain by its recitation that it was to be "coupled with the judgment entered on February 17, 1966 * * *". Just as plainly, respondent remained free to dispute on appeal the matters decided in 1966 on the basis of an adversarial contest.

From the foregoing, it is clear that taxpayers have had their day in court on this issue and are not entitled to any further consideration by this Court.

2. In our opening brief, the Government advanced the position, consistent with that taken in the court below, that the gain realized by the taxpayers from Trusts 473 and 482 in the Kearney Park note and land transaction was properly taxable as ordinary income in its entirety rather than as capital gains as held by the lower court. In advancing our basic contention, the Government divided the subject transaction into two categories, the proceeds from payment of the two Kearney Park notes and the proceeds from the disposition of the taxpayer's interests in the Kearney Park land securing the two notes. This approach is clearly consistent with that taken by this Court in Margolis v. Commissioner, 337 F. 2d 1001, 1009 (C.A. 9th, 1964).

With respect to the first category of gain, it is the Government's consistent position that the proceeds which are strictly attributable to payment of the notes represent the receipt of ordinary income since there is lacking the statutory requisite of a sale or exchange of a capital asset which would be necessary for capital gain treatment. See pages 19 and 20 of our original brief; Section 1222(3), Internal Revenue Code of 1954; Fairbanks v. United States, 306 U.S. 436.

In parts II and V of their brief (Br. 14-15, 28), taxpayers attempt to rebut the Government's contention with respect to gain from payment of the notes. They argue that the gain on the notes is not discount income and that the notes represent capital assets. However, the taxpayers conspicuously fail to make any attack upon the Government's main contention that the critical element of a sale or exchange is lacking. Taxpayers' failure to dispute this point is tantamount to an admission that the Government's position is correct and the judgment of the lower court should be reversed in this respect.

Also in part V of their brief (Br. 28) the taxpayers assert that this Court's decision in the Margolis case which allowed capital gains treatment with respect to the gain derived by Margolis from his sale of his beneficial interest in Trusts 473 and 482, which of course included the notes, settled the instant issue with respect to the taxability of the gain derived by the instant taxpayers from the payment of such notes out of the proceeds of the Navy purchase. But Margolis' situation in this respect is clearly distinguishable from

that of the taxpayers here in that the latter retained their beneficial interests in the two promissory notes until they were paid off from the proceeds of the Navy purchase. Thus, in their particular case the proceeds which represented payment of the face value of the two notes represented the extinguishment of the debtor's obligation, rather than the sale or exchange of an asset. Moreover, it is obvious, the taxpayers to the contrary notwithstanding (Br. 5), that it is immaterial that the payment for the land went from the Navy to the trustee of Trusts 473 and 482 rather than directly to the taxpayers. It had been agreed by the parties that the proceeds would be used to payoff the notes and in this situation the trustee was a mere conduit.

The second aspect of the case concerns the proper tax treatment of the gain realized on the sale of the Kearney Park land and that portion thereof transferred to the taxpayers in kind. Our position, consistent with this Court's statement in Margolis v. Commissioner, supra, p. 1009, is that taxpayers organized a joint venture with Margolis (who, unquestionably, as this Court held (p. 1009) was in the business of disposing of real estate) for the purpose of acquiring both the Kearney Park notes and an interest in the land securing the notes and accordingly held the subject property for sale to customers in the ordinary course of the business of the joint venture. Therefore, the interest in the real estate so disposed of is not a capital asset within the meaning of Section 1221 of the Code and does not qualify for capital gains treatment.

At the outset, taxpayers argue (Br. 16) that the transaction involving the disposition of the Kearney Park land to the Navy was an involuntary conversion rather than a sale. This contention is contrary to the findings of the lower court, which implicitly treated the transaction as a mere arm's-length transaction between buyer and seller. The record in this case discloses nothing more than the acquisition of the notes and interest in the Kearney Park land by taxpayers with a view towards sale to the Department of the Navy when funds for such purpose were made available by Congress, and that taxpayers voluntarily negotiated that sale as they would have done with any other class of purchaser. The taxpayers, seeking to uphold the judgment of the lower court, nonetheless desire to have this Court characterize the record evidence contrary to the District Court's characterization. But it is apparent there would be no basis for such action.

While not disputing the principle that ordinary income treatment may ensue where two or more individuals combine in a joint enterprise for their mutual benefit and the venture acquires property and holds it for sale to customers in the ordinary course of the business of that venture (Luckey v. Commissioner, 334 F. 2d 719 (C.A. 9th); Bauschard v. Commissioner, 279 F. 2d 115 (C.A. 6th); Zack v. Commissioner, 25 T.C. 676, affirmed per curiam, 245 F. 2d 235 (C.A. 6th); Brady v. Commissioner, 25 T.C. 682), the taxpayers seemingly argue (Br. 18) that that principle has no relevance in this case even if the instant taxpayers and Margolis organized a joint venture. This

argument apparently is to the effect (Br. 19) that since the taxpayers were not individually in the business of buying and selling real estate as was Margolis, it follows that their interests in the realty were capital assets.

In arguing as they do, taxpayers have miscontrued the plain language of this Court in the Margolis case, supra, p. 1009, which, we submit, clearly supports the Government's position with respect to the joint venture theory.

This Court stated therein that (p. 1009):

> By the agreement of June 15, 1956, the trusts acquired a new interest in the property -- a right to share in any gain upon their sale. * * * This right, secured by a trust deed to the property, constituted an interest in the equity of the property itself, which interest in property was held for sale by the trusts.

Because Margolis sold his interests prior to disposal by the trusts to the Navy, this Court further stated that (p. 1009):

> * * * it was proper to disregard the existence of these trusts and to construe the holding for sale as if it were by taxpayer himself and to construe his sale of his beneficial interests as a sale of property held for sale in the ordinary course of his business.

In the Margolis case it was necessary for this Court to in effect separate Margolis' holding from the trusts' holding since he disposed of his beneficial interests in the trusts prior to the time the trusts disposed of the joint interests of taxpayers. All these interests, as this Court stated, were held for sale by the trusts, i.e., the joint venturers composed of Margolis and the several taxpayers. Therefore, the net result is that Margolis and the taxpayers were organized into a joint venture for the purpose of acquiring real estate and for the

purpose of the eventual sale of the real estate to customers in the ordinary course of business. When the sale actually took place it was certainly a sale in the ordinary course of the business of that venture from which ordinary income treatment should ensue.[1/]

For the reasons stated in the Government's opening brief and for those stated above, the judgments of the lower court should be reversed in total and remanded for entry of judgments for the Government.

Respectfully submitted,

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OCTOBER, 1968.

1/ This conclusion would also be true even if contrary to this Court's ruling in Margolis, p. 1009, the trusts i.e., the venturers did not acquire an interest in the land itself, but merely purchased the right to receive income upon the final disposition of the property to the Navy. In such a situation the statutory requisite for a capital gain treatment could not have taken place, i.e., there would have been no sale, and the gain would still be taxable as ordinary income. Pounds v. United States, 372 F. 2d 342 (C.A. 5th). In this latter case the Court observed (p. 346):

> * * * where the taxpayer has only the right to share in the profits that might be realized, [his] interest cannot be treated as a capital asset. The definition of a capital asset must be narrowly applied and its exclusions interpreted broadly in order to effectuate the "Congressional purpose underlying the capital gains provision. Capital gains treatment was intended to relieve the taxpayer from the excessive tax burden on gain resulting from a conversion of capital investment. Corn Products Refining Co. v. Commissioner, 1955, 350 U.S. 46. * * *; Commissioner v. P. G. Lake, Inc., 1958, 356 U.S. 260, 265 * * *.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel, by mailing four copies thereof on this ______ day of October, 1968, in an envelope, with postage prepaid, properly addressed to him as follows:

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